No. 94-560

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1994

FIRST OPTIONS OF CHICAGO, INC.,

Petitioner,

vs.

MANUEL KAPLAN, CAROL KAPLAN AND M.K. INVESTMENTS, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF FOR AMICI CURIAE PHILADELPHIA STOCK EXCHANGE, INC., CHICAGO BOARD OPTIONS EXCHANGE, INC. AND PACIFIC STOCK EXCHANGE, INC. IN SUPPORT OF PETITIONER

LYDIA GAVALIS
Counsel of Record
Assistant General Counsel
Director of Arbitration

WILLIAM W. UCHIMOTO
General Counsel
First Vice President

Philadelphia Stock Exchange, Inc.
1900 Market Street
Philadelphia, PA 19103
(215) 496-5000

JOANNE MOFFIC-SILVER
Associate General Counsel
Attorney for Chicago Board Options Exchange, Inc.
Chicago Board Options Exchange, Inc.
400 South LaSalle Street
Chicago, IL 60605
(312) 786-7462

JOHN KATOVICH
Senior Vice President & General Counsel
ROSEMARY A. MACGUINNESS
Senior Counsel & Director of Arbitration
Attorneys for Pacific Stock Exchange, Inc.
Pacific Stock Exchange, Inc.
301 Pine Street
San Francisco, CA 94104
(415) 393-4066

Attorneys for Amici Curiae

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

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QUESTION PRESENTED

Whether a court reviewing an arbitration award under the Federal Arbitration Act should apply a de novo standard of review or the more deferential standard applied to arbitrators' decisions on the merits when reviewing the arbitrators' decision on arbitrability where the party objecting to arbitral jurisdiction had submitted the issue to the arbitrators for decision, as to which the courts of appeal are in conflict.

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STATEMENT OF INTEREST OF THE AMICI CURIAE

The Securities and Exchange Commission ("SEC"), pursuant to the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78a *et seq.*, has approved arbitration rules of the various self-regulatory organizations ("SROs") under the SEC's oversight.

Accordingly, the SROs have established SRO arbitration forums to resolve disputes between SRO members and between SRO members and their customers. Each

year thousands of disputes are fairly and efficiently resolved through binding SRO arbitrations that otherwise would clog state and federal court dockets, taxing not only judicial resources, but the parties' pocketbooks as well. The SRO securities arbitrations have been so effective that this Court has sounded a ringing endorsement of the program. *See Rodriguez De Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989). *See also Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

The Philadelphia Stock Exchange, Inc. ("PHLX"), Chicago Board Options Exchange, Inc., and Pacific Stock Exchange, Inc. are SROs registered with the SEC as national securities exchanges. The PHLX and other amici have established and maintained SRO arbitration programs. The amici have a significant and vital interest in the resolution of the issue in this case, specifically the standard of review to be applied to completed arbitrations.

In the instant case, the Third Circuit has dramatically undercut SRO arbitrators' ability to render final, binding arbitration decisions by allowing a court to re-examine *de novo* whether a dispute is arbitrable after the arbitrators have rendered a final decision regarding the merits of a dispute. This is especially disconcerting as the parties herein had participated in all aspects of the arbitration proceeding and had submitted the question of arbitral jurisdiction to the panel of arbitrators and did not in any manner reserve the question for determination by a court and/or seek immediate judicial intervention to review the arbitral jurisdiction issue. The Third Circuit's decision to subsequently review the jurisdiction issue *de novo* in

this case contravenes the clear federal policy in support of arbitration as a fair and efficient means of final and binding dispute resolution for those parties having submitted a dispute to arbitration.

If allowed to stand, the Third Circuit's decision in this case will inevitably have a deleterious impact on the SRO arbitration programs conducted by the amici. Initially, the Third Circuit's standard of *de novo* review will undercut the efficiency and certainty of binding SRO arbitration decisions. Ultimately, such *de novo* review will discourage willing participation by arbitrators as well as litigants in binding arbitration programs. The result will be that more securities disputes will be directed to the already overburdened courts.

SUMMARY OF ARGUMENT

Once parties have conferred on the arbitrators the authority to determine issues of arbitrability and, thereafter, have proceeded to the hearing on the merits before the arbitrators, the applicable standard of review of SRO arbitrators' decisions on arbitral jurisdiction should be the same standard accorded to the arbitrators' decisions on the merits of the dispute, namely deference. *See United Paperworkers Int'l Union, AFL-CIO v. Misco, Inc.*, 484 U.S. 29 (1987) (courts not authorized to challenge arbitrator's decision if arbitrator's authority drawn from essence of agreement). Essentially, this standard permits the courts to overturn the arbitrators' decisions only for a manifest disregard of the law (or as set forth in the applicable

statute). *See Nolde Brothers, Inc. v. Bakery Workers*, 430 U.S. 243 (1977). *See also Advest v. McCarthy*, 914 F.2d 6, 10 (1st Cir. 1990) (level of deference accorded arbitrator's selection of remedies greater than that accorded constitutional court); *Andros Compania Maritima v. Marc Rich and Co., A.G.*, 579 F.2d 691 (2d Cir. 1978) (even colorable justification for arbitrator's conclusion results in confirmation of award); *French v. Merrill, Lynch, Pierce, Fenner & Smith*, 784 F.2d 902 (9th Cir. 1986) (confirmation of award by court of appeals even if erroneous findings of fact and misrepresentation of law since agreement covers arbitrator's power to arbitrate).

This Court should resolve the split in the circuits by reaffirming the deferential standard, which provides that once an arbitration decision is rendered as to the merits of a dispute, all substantive decisions made by the arbitrators that led to the final decision on the merits, including any decision as to the arbitrability of the dispute, should receive, if appealed, deferential review by a court. This Court has held in numerous arbitration contexts that arbitrators' discretion in rendering final decisions is broad and that a court's interference with that discretion is inappropriate. This view is consistent with the policies underlying the Federal Arbitration Act, the federal securities laws' policy favoring arbitration of securities disputes, and this Court's own preference for securities dispute resolution through SEC approved and regulated SRO arbitration programs.

ARGUMENT

I.

THE THIRD CIRCUIT DECISION INAPPROPRIATELY UNDERMINES THE SECURITIES ARBITRATION SCHEME

The recent Third Circuit decision shocks basic contract law principles relating to whether parties have agreed to binding arbitration, and upsets the entire bedrock of the SRO securities arbitration scheme.

The amici urge this Court to reaffirm the deferential standard of judicial review of final arbitration awards. Once securities arbitrators have been permitted by the parties to render a final decision on the merits, a reviewing court must be deferential to the arbitrators' decision when reviewing any predicate decisions to that final decision, including any decision as to arbitrability of the dispute by the arbitrators. The corollary standard would be that if a party seeks to contest whether a matter is arbitrable or whether such party is subject to an agreement to arbitrate, that party must immediately seek a judicial determination as to such issue[s] and/or expressly reserve such right prior to a final decision by the arbitrators on the merits of the dispute. Failure to take such actions would constitute a *per se* waiver or estoppel of any right by any party to *de novo* court review of the issue of arbitrability. *See Teamsters Local Union v. J.H. Merritt & Co.*, 770 F.2d 40, 42-43 (3d Cir. 1985). *See also Interstate Brands Corp. v. Chauffers, Teamsters, Warehousmen & Helpers, Local Union No. 135*, 909 F.2d 886 (6th Cir. 1990), cert. denied, 499 U.S. 905 (1991) (if neither party objects to arbitrability decision of arbitrator, parties

deemed to implicitly agree to arbitration); *Piggly Wiggly Operators Warehouse Inc. v. Piggly Wiggly Operators Warehouse Independent Truck Driver's Union*, 611 F.2d 580 (5th Cir. 1980) (grievance submitted to arbitrator defines authority without regard to prior legal obligation to submit dispute).

However, in this and a series of other cases, the Third Circuit has reasoned that it was enough for a party to merely object to whether a dispute is arbitrable. These courts conclude that even if a party proceeds with costly, time-consuming proceedings to a final decision by the arbitrators on the merits of the dispute, the objecting party has not waived the right to a judicial determination of the arbitrability issue, and the reviewing court may even conduct a full *de novo* review of the issue of arbitrability, which can totally undermine the entire completed proceeding. *See Pennsylvania Power Co. v. Local Union No. 272*, 886 F.2d 46, 51 (3d Cir. 1989). *See also Local 719, American Bakery & Confectionery Workers of America, AFL-CIO v. The National Biscuit Company*, 378 F.2d 918, 921 (3d Cir. 1967).

De novo review with regard to the issue of arbitrability undermines the efficacy of the entire arbitration process when, as in the instant case, the parties have appeared before the arbitrators, participated in preliminary hearing conferences, conferred the power and authority on the arbitrators with respect to the resolution of the issue of jurisdiction/arbitrability, and thereafter proceeded and allowed the arbitrators to render a final decision on the dispute's merits.

On July 24, 1989, the Respondents in this case filed with the PHLX arbitrators a substantial counterclaim and an answer to the statement of claim filed by Petitioner, who was the arbitration Claimant. Respondents' answer denied liability and objected to the PHLX's arbitral jurisdiction. This jurisdictional objection was orally withdrawn by Respondents' counsel of record during a preliminary hearing held on February 26, 1990. That being the case, the PHLX arbitrators and Petitioner were justifiably led to believe that the arbitrability question was no longer an issue. Not until January 6, 1992, through Respondents' newly retained counsel, did the arbitrability issue again arise via a Motion to Dismiss for Lack of Jurisdiction ("Motion"). On January 10, 1992, the arbitrators denied Respondents' Motion. Petitioner reasonably relied on these actions and concluded that the arbitrators' determination with regard to jurisdiction was final, in that Respondents in no manner again raised and/or reserved the arbitrability objection during the remainder of the proceeding, including during the eight days of hearing sessions that were conducted on the merits of the case.

Under the aforementioned circumstances, the Third Circuit's invocation of *de novo* review of whether the arbitrators possessed arbitral jurisdiction over the parties in this arbitration is inappropriate for many reasons. First, a standard of *de novo* review in this particular case creates substantial unfairness. The standard of allowing parties who lose in arbitration to defer judicial review of the arbitrators' decision on arbitral jurisdiction enables such arbitration parties to retain their jurisdictional argument as insurance, while attempting first to prevail on

the merits. If a party prevails on the merits, then no appeal is taken. On the other hand, if the party loses, he or she would have every incentive to revive his or her jurisdictional challenge and request the court to overturn the arbitration award through a *de novo* review regarding whether the matter was arbitrable in the first instance. Hence, the objecting party is unfairly allowed to hold an "ace in the hole" while the opposing party is required to play all its cards.

Second, significant resources are utterly wasted when an arbitration award is reversed by a court's "second guessing" of arbitral jurisdiction after the entire arbitration has run its course. In this arbitration case alone, thousands of hours were expended by the Exchange arbitration administrators, arbitrators, witnesses and the parties themselves, all to no ultimate avail in the effort to create a final, binding resolution of the dispute. Those thousands of hours reflect hundreds of thousands of dollars in time and effort wasted. According to the Third Circuit, this case must now be relitigated in court all over again. Affording deference to the arbitrators' award, including the decision on the arbitrability of the dispute, would have appropriately assured binding finality to this case. This is especially true since the Respondents had submitted the question of jurisdiction to the arbitrators, had failed to reserve the question of judicial review (that action constituting a waiver of objections to the arbitrators' jurisdiction) and thereafter had proceeded on the merits to the conclusion of the matter. At no time had Respondents reserved or sought judicial review with regard to the arbitrators' decision on jurisdiction prior to the arbitrators' decision on the merits.

The deferential standard is the only standard of review that is consonant with the strong federal policies favoring the resolution of disputes through binding arbitration and this Court's previous support of securities arbitration. *See United Steelworkers of America v. American Manufacturing Company*, 363 U.S. 564 (1960). *See also Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

Third, basic contract principles mandate a deferential standard of review of decisions regarding arbitrability. In this regard, the Third Circuit disregarded basic contract law when it decided that parties do not expressly or by implication waive their right to *de novo* judicial review of the arbitrability issue when they merely object to jurisdiction, yet present the issue of jurisdiction to the arbitrators and then pursue to conclusion costly and time-consuming proceedings on the merits of the dispute. *See* Restatement Second of Contracts § 84 (1981). *See also Reiter v. Yellowstone County, Montana et al.*, 627 P.2d 845, 850 (1981) (defined implied waiver as detrimental reliance). Moreover, by not finding such a waiver, the Third Circuit ignored principles of estoppel and good faith and fair dealing. All parties spent considerable time and money on the arbitration proceedings and relied to their detriment on the objecting parties' "good faith" participation in these proceedings. *See* Restatement Second of Contracts §§ 34, 84, 90 and 205 (1981). *See also Neverett v. Towne*, 159 A.2d 345, 351 (1960) (defendant subject to estoppel where plaintiff detrimentally relied on defendant's misrepresentation).

Finally, the Third Circuit decision places a chilling effect on the arbitral process by encouraging SRO arbitrators to

either refuse to accept or to readily dismiss matters involving jurisdictional objections as submitted for resolution to them by the parties. The practical result is an increase in both state and federal court dockets and a delay in the processing of securities disputes, which runs afoul of the federal policies favoring fair, efficient and speedy resolution of these cases through arbitration.

CONCLUSION

For the aforementioned reasons, the amici respectfully request this Court to reverse the Third Circuit's decision on the standard of review and re-establish a uniform, nationwide standard of deferential review of arbitrators' decisions on the issue of arbitrability. The deferential standard is particularly compelling when, as in this case, the objecting party freely submitted the issue to the arbitrators for a determination without reservation. We look for this Court to once again restore the SRO arbitration fora to their original and intended purpose - swift, just, effective and consistent securities dispute resolution.

Respectfully submitted,

WILLIAM W. UCHIMOTO
General Counsel
First Vice President

LYDIA GAVALIS
Assistant General Counsel
Director of Arbitration

Attorneys for Amicus Curiae

Philadelphia Stock Exchange, Inc.
1900 Market Street
Philadelphia, PA 19103
(215) 496-5000